No. 18,416

IN THE

United States Court of Appeals

For the Ninth Circuit

HANS ZIMMERMAN and CLARA D. ZIMMERMAN,
Appellants,

v.

UNITED STATES OF AMERICA and the DISTRICT DIRECTOR OF INTERNAL REVENUE FOR THE STATE OF HAWAII,
Appellees.

On Appeal From the Judgment of the United States District Court for the District of Hawaii

BRIEF FOR THE APPELLEES

LOUIS F. OBERDORFER,
Assistant Attorney General,

LEE A. JACKSON,
ROBERT N. ANDERSON,
ALAN D. PEKELNER,
Attorneys,
Department of Justice,
Washington 25, D. C.

HERMAN T. F. LUM,
United States Attorney.

Recorder Printing and Publishing Co., San Francisco

INDEX

CITATIONS

Cases

Statutes

Miscellaneous

No. 18416

In The

United States Court of Appeals

For the Ninth Circuit

Hans Zimmerman and Clara D. Zimmerman,

Appellants,

v.

United States of America and the District Director of Internal Revenue for the State of Hawaii,

Appellees.

On Appeal From the Judgment of the United States District Court for the District of Hawaii

BRIEF FOR THE APPELLEES

OPINION BELOW

The findings of fact, conclusions of law and opinion f the District Court (I R. 12-21)[1] are officially re-orted at 209 F. Supp. 312 (D. Hawaii).

JURISDICTION

The appeal in this case involves federal income tax or the calendar year 1955 in the amount of $13,180.66.

[1] "I R." references are to volume one of the transcript of record. "II R." and II R." references are to volumes two and three of the transcript of record, spectively.

Alternatively, this case involves federal income tax for any of the calendar years 1949 through 1954. (I R. 9.) The taxes for the year 1955 were paid by the taxpayer[2] on or about January 30, 1956, when his tax return was filed. (Ex. E, p. 1.) Within the time provided by Section 6511(d) of the Internal Revenue Code of 1954 and on October 2, 1957, claims for refunds for the taxable years 1950 through 1955 were filed. Within the time provided by Section 6511(d), and on March 14, 1957, a claim for refund for the taxable year 1949 was filed. (See I R. 5.) Notices of disallowance with regard to the refund claims for the years 1949 through 1955 were mailed to the taxpayer. Within the time provided by Section 6532 of the Internal Revenue Code of 1954, and on May 7, 1958, this action was commenced in the District Court of Hawaii for the recovery of taxes and interest paid. (I R. 1-6.) Jurisdiction was conferred on the District Court by 28 U.S.C., Section 1346. Judgment for the Government was entered by the District Court on August 14, 1962. (I R. 23.) A motion for a new trial or to open judgment (I R. 25-29) was filed by taxpayer on August 17, 1962 (I R. 29). This motion was denied by order of the District Court dated September 19, 1962. (I R. 37.) Within 60 days thereof, and on October 19, 1962, taxpayer filed a notice of appeal. (I R. 39.) Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

QUESTIONS PRESENTED

Whether amounts contributed by the taxpayer to the National Medical Society were deductible by him in

[2]Although joint returns were filed by taxpayer and his wife, for convenience this brief will refer to Mr. Zimmerman as the sole taxpayer.

1955, or any other year here involved, as a business or nonbusiness bad debt within the meaning of Section 166 of the Internal Revenue Code of 1954.

STATUTES AND REGULATIONS INVOLVED

The relevant statutes and Treasury Regulations are set forth in the Appendix, *infra*.

STATEMENT

This appeal arises from a refund action in which the taxpayer claimed among other things a deduction for an alleged debt that was said to have become worthless during 1955 or, alternatively, during any of the years 1949 through 1954. (I R. 4, 5.) The facts surrounding taxpayer's bad debt allegation (see I R. 12-18) may be stated as follows:

Prior to December 7, 1941, Dr. Hans Zimmerman, the taxpayer, practiced naturopathy in Honolulu, Hawaii. At the outbreak of the Second World War, taxpayer was immediately interned by the United States Army and was thereafter shipped to the mainland of the United States. (I R. 12.)[3] Taxpayer was not permitted to return to Hawaii until 1946. (See II R. 51-52.)

---

[3]Upon Dr. Zimmerman's internment, his wife, Clara, brought a habeas corpus action to obtain his release. Her habeas corpus petition was denied by the District Court; seemingly, that court believed the habeas corpus petition well taken, but felt itself powerless to act on the petition due to the existence of martial law in Hawaii. The District Court's opinion, unreported, was affirmed on appeal. See *Ex Parte Zimmerman*, 132 F. 2d 442 (C.A. 9th), certiorari denied *sub nom, Zimmerman* v. *Walker*, 319 U.S. 744. While on the mainland during the war, taxpayer was convicted of and fined $100 for violation of the Illinois Medical Practice Act. See *People* v. *Zimmerman*, 391 Ill. 621, 63 N.E. 2d 850. After the war, when Dr. Zimmerman returned to Hawaii, he sued for damages arising from his internment and subsequent shipment to the mainland. Apparently, because of the Supreme Court's decision in *Duncan* v. *Kahanamoku*, 327 U.S. 304, Zimmerman's damage suit was not dismissed. See *Zimmerman* v. *Poindexter*, 74 F. Supp. 933 (D. Hawaii), and *Zimmerman* v. *Poindexter*,

Taxpayer, while engaged in his pre-war naturopathy practice, had had disagreements with the American Medical Association (AMA) concerning certain legislation. Because of these disagreements and because taxpayer was "interested in preserving our profession," taxpayer decided that certain healing professions — naturopaths, homeopaths, allopaths, osteopaths—should combine on a national scale to promote the following: preservation of their professional rights in the face of AMA opposition; more recognition and better legislative treatment from the various states; establishment of a school to teach the arts of their several professions; and, establishment of a hospital in Honolulu with all healing arts represented. Accordingly, in 1944 the National Medical Society (NMS) was founded with taxpayer as its first president. Shortly thereafter taxpayer was elected NMS's executive secretary and held that position until 1949 when he became chairman of NMS's board. (I R. 12-13.) Taxpayer devoted most of his time to NMS organizational work travelling extensively on its behalf to obtain new members, organize chapters, and attempting to start a school for the above-mentioned healing arts at the University of Tampa, Florida. The

---

78 F. Supp. 421 (D. Hawaii). The action went to the jury which, after being out for more than 24 hours, acquitted the defendants. The verdict was affirmed by this Court. *Zimmerman* v. *Emmons,* 225 F. 2d 97 (C.A. 9th), certiorari denied, 350 U.S. 932.

On his income tax returns for 1954 and 1955, Dr. Zimmerman deducted the attorneys' fees expended in the damage suit. The Commissioner disallowed the deduction. Taxpayer paid the amounts of tax attributable to the sums disallowed, filed claims for refund, and after his claims for refund were denied, filed this suit for refund in the District Court. The attorneys' fees issue were counts I and II of taxpayer's complaint. Taxpayer also included in his complaint as count III, a claim for a refund arising out of an alleged bad debt loss. On the legal fees issue, summary judgment was entered for the taxpayer. The Government has not appealed that decision. On count III, however, involving the alleged bad debt loss, decision was entered for the Government (I R. 23) from which decision taxpayer has appealed (I R. 38-39). Thus, the bad debt issue is the only aspect of this litigation now before this Court.

Society also undertook to publish a journal (Journal of the National Medical Society) of which the taxpayer was the editor. (I R. 13.)

At its inception, NMS had no funds. Taxpayer offered to advance NMS money until it could support itself. Taxpayer said that he expected repayment out of NMS's membership dues but a specific time for repayment was never mentioned. (I R. 13.) Although taxpayer testified that he expected NMS to have 50,000 members—since there were 50,000 practitioners of the healing arts involved (II R. 42)—at the end of 1945 there were not more than 100 regular dues-paying members (I R. 14).

During 1944 and 1945, taxpayer made substantial advances to NMS for its office and business expenses and to pay for his travel. (I R. 13.) NMS's minutes show that on April 5, 1944, taxpayer "offered to advance the finances necessary to set up administrative headquarters," and the subsequent minutes show that taxpayer was authorized to and did travel all over the United States setting up local chapters, investigating the Hoxsey cancer treatment, etc. (I R. 16.) In NMS's August 1, 1945, minutes, after a complaint that taxpayer had spent money too lavishly in promoting NMS, there appeared the following (I R. 16-17):

> * * * [the] legal adviser explained our liability relative to same and it was agreed that as the Society was able that after an accounting of monies spent, what was coming to Dr. Zimmerman, should be gradually repaid. This seemed agreeable to all under conditions as presented.

The taxpayer was present at this meeting.

As of August 7, 1945, the accountants' records show that there was then due taxpayer $5,538.55 for money advanced to NMS. At that time, there was a deficit of expenses over income of $3,963.89. By October 2, 1945, cash advanced by taxpayer had reached $6,491. On October 20, 1945, a motion was unanimously passed at the "First Annual Convention" of NMS that "Dr. Zimmerman be repaid the monies (he) advanced to the society at the earliest opportunity." (I R. 17.)

Taxpayer, though returning to Hawaii in 1946 to resume his naturopathy practice, continued to actively promote NMS and to advance it funds because, apparently, NMS never became self-supporting. (I R. 13-14.)

While the records for the years between 1945 and 1949 were not available taxpayer, at the end of 1949, claimed $32,518.72 was due him from NMS. (I R. 17.)

In taxpayer's 1946 return, he deducted $5,000 that he had *"contributed"* to NMS. This $5,000 was included in the $41,247.73 referred to above, as were the following similarly listed "contributions" on his and his wife's joint tax returns (I R. 14):

Year	*Amount*
1951	$3,000
1952	1,000
1953	1,000
1955	2,100

The District Court found that there was no specific correlation between actual advances to NMS and "contributions" reported on taxpayer's 1951, 1952, 1953 and

1955 income tax returns (I R. 14), as can be shown by the following table (I R. 14-15):

Year	*Actual Advances*	*Contributions*[4]
1951	$1,683.22	$3,000.00
1952	963.05	1,000.00
1953 and 1954 ...	1,153.95	1953 – 1,000.00
1955	51.25	2,100.00

A report from an accounting firm showed that as of December 31, 1949, dues due and uncollectible from NMS members amounted to $2,362, leaving but 59 annual members who were truly expected to pay the $10 annual dues. At that time, taxpayer "confirmed" to the accountants that NMS owed him $32,518.72 although NMS's total assets were but $5,706.97. During 1949, although NMS's total income from all sources was only $1,429,[5] taxpayer advanced NMS $11,694.70. Taxpayer subsequently advanced NMS the following amounts (I R. 15): 1950, $8,852.64; 1951, $1,683.22; 1952, $963.06; 1953 and 1954, $1,153.95; 1955, $51.25. Between 1944 and 1955, taxpayer advanced to or paid out for NMS some $50,000. He testified at the trial that some $10,000 of the advances were repaid, but he did not specify at what time. (I R. 14.) The minutes of NMS of July 18, 1954, show that it was unanimously agreed that the Society should reimburse the "expenses advanced by Executive Secretary, Dr. Hans Zimmerman amounting to $10 per day, and travelling expenses

[4]In 1956, the Internal Revenue Service rejected the deductions taken by taxpayer for "contributions" and "donations." The Service maintained that the NMS was a business league and not a type of organization contributions to which could be deducted for tax purposes. (I R. 15.)

[5]The $1,429 total came from a combination of membership fees, dues collected, Journal advertising, Journal subscriptions, sale of car emblems, and sale of car buttons. (I R. 15.)

for administrating the affairs of the N.M.S." At the end of 1955, it appeared that $41,247.73 advanced by taxpayer had not been repaid. (I R. 14.)

The regular dues-paying membership of the NMS never at any time exceeded over three low figures. This was known to taxpayer as he was making his advances. (I R. 15.) In a letter dated May 14, 1955, published in the Journal of the National Medical Society, Vol. 1, No. 3, p. 91, the statement is made that "Dr. Zimmerman had an idea, and he toiled day and night to put his idea into effect. Besides unselfishly devoting his whole time, he also made financial contributions so that the seeds could be sown, which have borne fruit with the growth of the National Medical Society * * * let our slogan be 'New Members,' and repay a debt of gratitude to Dr. Hans Zimmerman." (I R. 13.)

Taxpayer testified at the trial that "the minutes of the meetings reveal the subject, but primarily, I offered to advance the money until the time when the organization could carry itself financially, and then that the organization should repay me at whatever amount that was possible without jeopardizing the organization." (I R. 17.)

Based on the foregoing the District Court found (I R. 17-18):

> The evidence is conclusive that the members and directors of the Society were filled with good intentions to repay Dr. Zimmerman for the monies he had advanced, but the records, as well as Dr. Zimmerman's testimony, unequivocally show that there was *never* any specific time or manner in which these monies should be repaid him. The records also clearly indicate that year after year

Dr. Zimmerman continued to advance monies far in excess of the income of the Society—long after, with his inside knowledge of the financial affairs of the Society, he could have ever reasonably believed that there was any possibility—let alone probability—of repayment.

There was never any specific date by which any of the monies advanced by him were to be repaid, the "contingency" upon which it was to be repaid—if at all—was as stated by the Doctor and as set forth in the minutes: when and if the Society was able, he should be repaid, gradually, at the earliest opportunity, whatever amount the Society found possible to repay, without jeopardizing its financial condition. The contingency, loose and indefinite as it was, never did occur, and at no time could the Society have been forced by Zimmerman, on the specific circumstances above indicated, to repay the same to him. The fact that he, himself, reported the advances from time to time as "donations" and "contributions," coupled with the fact that he continued to make advances in very substantial amounts, far, far in excess of the Society's income, without receiving any note or any other evidence of indebtedness—even by way of records in the minutes—of the Society's promise to repay him, all indicate that he never actually expected, but rather only hoped, to be repaid any of the monies which he continued to advance.

Accordingly, the District Court concluded that "none f the normal indicia of a classic debt appear in this ase" (I R. 20) and further that the taxpayer's adances to NMS do "not fit into any of the accepted efinitions of a 'debt' either business or non-business, ithin the meaning of the Internal Revenue Code"

(I R. 21). The court then ordered judgment to be entered for the Government. (I R. 21.) On October 19, 1962, subsequent to the denial of his motion for new trial or to open judgment, taxpayer filed a notice of appeal from the judgment of the District Court. (I R. 39.)

SUMMARY OF ARGUMENT

An unrepaid advance to a corporation can be deducted by a taxpayer under Section 166 of the 1954 Code only if that unrepaid advance is a "debt." It is clear that none of the classic criteria of a debt exist in this case. The record shows that taxpayer's advances to NMS never had a fixed maturity date for repayment, that taxpayer never demanded repayment, that interest was never charged, and that taxpayer never asked for security to insure repayment. Moreover, repayment depended upon a contingency—NMS's financial success—which never occurred so that a debt cannot be said to have come into existence.

The factual setting in which taxpayer advanced NMS funds makes it certain that gifts or contributions, not loans, were intended. The taxpayer himself deducted a large part of the advances as charitable contributions on his tax returns and, in addition, NMS's minutes and correspondence establish that the advances were at all times considered contributions. Furthermore, it is clear that when one advances money without expecting repayment, a contribution or gift is intended. The dire financial circumstances of NMS, of which taxpayer was fully aware, but, nevertheless, continuously poured money into the organization, shows that taxpayer never seriously expected to be repaid. The record well estab-

lishes that taxpayer gave or contributed money to NMS, but did not make it a loan.

Furthermore, the statute places the burden upon the taxpayer to establish the year in which a bad debt loss occurs. In his complaint taxpayer did not specify any single year in which the alleged loss occurred, but rather alleged that it occurred in *any* year between 1949 and 1955. At the trial taxpayer did not establish the year of loss, and accordingly the trial court was unable to make any finding as to the exact year of loss. Consequently, taxpayer has not met the burden placed upon him by the statute, i.e., of establishing the *year* in which the alleged debt became worthless.

As an alternative argument the Government contends that if taxpayer's advances be found to be a debt, they should also be found to be a nonbusiness debt. Taxpayer was a naturopath and he testified that he had no business other than that of practicing naturopathy; taxpayer was not in the business of a promoter or dealer in societies or corporations. It is well established that a mere stockholder's relationship to a corporation (analogous to the relationship of taxpayer to NMS here) cannot give rise to a business bad-debt loss deduction in favor of the stockholder since the business of a corporation is separate and distinct from that of its shareholders. Moreover, organizing, financing, and managing a corporation is not a separate "trade or business" if the taxpayer's only return is the increased value and earning capacity of his corporate investment.

Taxpayer's ownership rights in NMS here were those only of a single member. As the years went by taxpayer's role in the management of NMS's affairs dimin-

ished. He never received a salary, remuneration, or profit from NMS. Indeed, taxpayer's advances to NMS were not motivated by a current profit motive but rather by his personal opposition to the American Medical Association.

In view of the foregoing, taxpayer cannot deduct his alleged loss as a business bad debt since it was not incurred in his only trade or business, i.e., the practice of naturopathy.

ARGUMENT

The District Court Correctly Determined That Amounts Contributed by the Taxpayer to the National Medical Society Were Not Deductible by Him in 1955, or Any Other Year Here Involved, as a Business or Nonbusiness Bad Debt Within the Meaning of Section 166 of the Internal Revenue Code of 1954.

A. Introduction

Under Section 166(a) of the Internal Revenue Code of 1954, Appendix, *infra,* there is allowed as a deduction from gross income "any debt which becomes worthless within the taxable year."[6] The taxpayer here advanced funds to the National Medical Society, an organization of which he was a founder (II R. 9-10), and because these advances have not been repaid taxpayer alleges he is entitled to a bad debt deduction. We start out, however, with the well-settled principle that since deductions are a matter of legislative grace, the

[6]Under subsection (d) of Section 166, in the case of a taxpayer other than a corporation, however, subsection (a) does not apply to any nonbusiness debt. A nonbusiness bad debt, under subsection (d), is treated as a loss from a sale of assets held for not more than six months. Such a taxpayer, therefore, is limited, on a nonbusiness bad debt loss, to a maximum deduction of $1,000 in any taxable year. However, where a nonbusiness loss exceeds $1,000, it may, to the extent such loss exceeds net capital gains, be carried over to the next five taxable years. Internal Revenue Code of 1954, Section 1212.

taxpayer bears the burden of proving that he is entitled to the claimed deduction. *New Colonial Co.* v. *Helvering,* 292 U.S. 435; *Alexander & Baldwin* v. *Kanne,* 190 F. 2d 153 (C.A. 9th). It is clear that not every unpaid advance is a debt. *Alexander & Baldwin* v. *Kanne, supra.* The Commissioner contends that for an unpaid advance to be a debt several criteria, more fully set forth, *infra,* must be met, and that taxpayer has not borne his burden of establishing that he has satisfied these criteria. The District Court, after studying taxpayer's testimony[7] and exhibits adduced, made the ultimate factual finding that whatever obligation NMS had with respect to taxpayer's advances to it, such obligation did not constitute a "debt," either business or nonbusiness, within the meaning of Section 166. (I R. 21.) We submit that this factual finding of the District Court was not clearly erroneous (see *Commissioner* v. *Duberstein,* 363 U.S. 278, 291; *Lundgren* v. *Freeman,* 307 F. 2d 104, 114-115), was supported by substantial evidence, and should therefore be affirmed on appeal.

B. There Was Never a Debtor-Creditor Relationship Established Between the NMS and the Taxpayer, Consequently, the Amounts Advanced to NMS by Taxpayer Were Not Debts Within the Meaning of Section 166 of the Internal Revenue Code of 1954.

1. NMS Never Had an Unconditional and Legally Enforceable Obligation to Repay Taxpayer.

A debt's essential characteristic is that there is "an unconditional and legally enforceable obligation for the

[7]There were no witnesses other than taxpayer. It is well settled, of course, that the trier of fact was "not obliged to accept as true" the testimony of this interested witness. *Helvering* v. *Nat. Grocery Co.,* 304 U.S. 282, 295, rehearing denied, 305 U.S. 669. See also concurring opinions in *Pacific Homes* v. *United States,* 230 F. 2d 755, 761 (C.A. 9th) and *Wilkerson Daily Corp.* v. *Commissioner,* 125 F. 2d 998, 999 (C.A. 9th).

payment of money." *Commissioner* v. *McKay Products Corp.,* 178 F. 2d 639, 644 (C.A. 3rd). As was said in *Gilbert* v. *Commissioner,* 248 F. 2d 399, 402 (C.A. 2d)—

> The classic debt is an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof. While some variation from this formula is not fatal to the taxpayer's effort to have the advance treated as a debt for tax purposes, * * * too great a variation will of course preclude such treatment.

It is clear that none of the classic criteria of a debt exist in this case. To begin with, there never was a fixed (or even "reasonably close fixed") maturity date set for repayment. (I R. 18.) NMS's liability, if such may be said to have existed at all, was for repayment at an uncertain future time; whenever NMS could repay taxpayer without jeopardizing its financial condition. (I R. 17-18.) Of course, no one knew when that time would come about. Taxpayer's testimony clearly establishes that there was no fixed maturity date. Taxpayer testified (II R. 14):

> Q. Did you have an arrangement with them by which they would repay money that you advanced to them?
>
> A. Yes.
>
> Q. Would you state to the court what your understanding with the organization was?
>
> A. Well, the minutes of the meetings reveal the subject, but primarily I offered to advance the

money until the time when the organization could carry itself financially, and then that the organization should repay me at whatever amount that was possible without jeopardizing the organization.

Q. What was the understanding as to how you were to be paid for monies loaned to the National Medical Society?

A. I was going to be repaid from the dues collected.

Q. Was there any specific time mentioned for repayment of the monies that you were to advance or loan to them?

A. No, no specific time.

The minutes of an NMS meeting of August 1, 1945, state: "it was agreed that as the Society was able * * * [taxpayer] should be gradually repaid." (I R. 16.) Indeed, at an NMS business meeting on October 20, 1945, the following occurred (I R. 55):

> Dr. Wolfram then introduced a motion that Dr. Zimmerman [taxpayer] and Dr. Zigament be repaid the monies they advanced to the Society at the *earliest opportunity*. This was recorded by Dr. Neale. Unanimous approval was signified. (Emphasis supplied.)

Thus, both taxpayer's testimony and NMS's minutes forcefully support the District Court's finding that (I R. 17-18)—

> There was never any specific date by which any of the monies advanced by him were to be repaid, the "contingency" upon which it was to be repaid—if at all—was as stated by the Doctor and as set

forth in the minutes: when and if the Society was able, he should be repaid, gradually, at the earliest opportunity, whatever amount the Society found possible to repay, without jeopardizing its financial condition.

If a fixed maturity date was the only variation from the classic debt, possibly, taxpayer might still be entitled to a bad debt deduction. *Gilbert* v. *Commissioner, supra.* The record, however, contains no positive indication or even an inference that taxpayer ever made a demand for repayment, provided for interest on the amounts allegedly loaned, or asked for security to insure repayments. The absence of these three factors, together with lack of a fixed maturity date, has recently been held to establish that an advance was not a debt. *Ludwig Baumann & Co.* v. *Commissioner* (C.A. 2d) decided February 4, 1963 (63-1 U.S.T.C., par. 9261). In addition, however, in the instant case there never was an unqualified obligation to repay taxpayer since payment was contingent upon NMS achieving financial stability. This contingency — financial success — never occurred. (I R. 18; see II R. 37.) Nor, in the light of NMS's undisputed financial history, was there even the slightest possibility that it would occur. Where repayment depends upon a contingency, a debt does not arise until the contingency occurs, since before the contingency's happening no money will be owed. *Alexander & Baldwin* v. *Kanne, supra; Milton Bradley Co.* v. *United States,* 146 F. 2d 541 (C.A. 1st); *Bercaw* v. *Commissioner,* 165 F. 2d 521 (C.A. 4th); *United States* v. *Virgin,* 230 F. 2d 880 (C.A. 5th). NMS was under no duty to repay taxpayer because the contingency of financial success had not occurred and, therefore, a debt

had not come into existence. In *Alexander & Baldwin* v. *Kanne, supra,* taxpayer had contributed $50,000 to a trust company that was liquidating the assets of another company in financial distress. There, the $50,000 was repayable "only when, if and to the extent that" (p. 154) after all the indebtedness and liquidation costs of the distressed company were repaid there remained an excess of assets. As things worked out, no assets remained after payment of the distressed company's indebtedness and liquidation costs. Because the contingency did not occur—no assets remained after liquidation—this Court held that a debt had not arisen and, accordingly, that taxpayer could not deduct as a bad debt the $50,000 he had advanced. See also, *Milton Bradley Co.* v. *United States, supra; cf., United States* v. *Virgin, supra.* As the contingency herein never occurred — NMS was never financially successful — taxpayer should also be precluded from taking a bad debt deduction for here too a debt never existed.

2. Taxpayer's Advances to NMS Were Gifts or Contributions and Not Loans.

We submit that the circumstances surrounding taxpayer's advances clearly establish that gifts or contributions—not loans—were intended. If this be so, a debtor-creditor relationship was not entered into and any unpaid advance did not constitute a "debt." At the outset, we cannot help but call to this Court's attention the fact that taxpayer deducted $12,100 of the $41,247.73 advanced as *charitable contributions* on his 1946, 1951, 1952, 1953 and 1955 income tax returns. (I R. 14.) Evidently, taxpayer himself considered his advances as being contributions. Contrary to taxpayer's assertion

(Br. 23-26), the record (I R. 58-61) does not disclose that taxpayer maintained separate accounts for contributions and advances. If anything, a single account was used in recording his transactions with NMS. His taking of only a portion of his advances as deductions on his income tax returns is a fact consistent with a taxpayer trying to salvage, through a tax benefit, some portion of an otherwise unrepaid advance.[8]

In any event, the Tax Court had before it several additional indicants that taxpayer's advances were contributions. NMS's by-laws declared that funds should be raised by "dues and *special contributions*" (emphasis supplied). (I R. 50.) A letter to NMS by a Captain Leahy (I R. 52) praises taxpayer's "financial contributions" and does not suggest that the advances were considered loans. Dr. Gobar (NMS's president) stated in a letter to taxpayer (I R. 68-70) dated March 18, 1949 (I R. 70): "The Society needs you. You need the Society to pay off *the already large sum you have altruistically spent* in the interests of the Society" (emphasis supplied). Taxpayer's return letter, dated March 22, 1949 (I R. 71), did not contain any denial of the alleged altruistic motive. Furthermore, NMS's balance sheet for December 31, 1949, shows that taxpayer's advances up to that date of $32,518.72 were treated as or considered to be capital contributions or paid-in surplus because there was offset against that figure surplus losses attributable to operations of $30,351.01 leaving a net worth of $2,167.71. Had taxpayer's advances been treated as a liability of NMS, as taxpayer

[8]At the time taxpayer filed his return he was not aware that a bad debt was deductible (I R. 4.)

contends, there would have been a surplus deficit according to this balance sheet of $60,702.02. (I R. 67.)

Moreover, it is clear that taxpayer's advances were made at times when repayment was unlikely,[9] a sure indicant that a loan was not intended. *Shiman* v. *Commissioner,* 60 F. 2d 65 (C.A. 2d); *Gilbert* v. *Commissioner, supra*; *Kinkead* v. *Commissioner,* 71 F. 2d 522 (C.A. 3d); *W. F. Young, Inc.* v. *Commissioner,* 120 F. 2d 159 (C.A. 1st). Taxpayer testified repayment was expected out of membership dues and that NMS was expected to have 50,000 members. (I R. 13; II R. 16.) However, this initial expectation was itself predicated upon a belief that every healing practitioner in the country would join NMS.[10] On cross-examination, taxpayer stated (II R. 42):

> Q. Now, how did you come — how did the organization come to the conclusion that there would be a membership of 50,000?
>
> A. By knowing how many practitioners of other healing arts are in existence.
>
> Q. That is the only basis by which you determined that there was an expectation of 50,000 members, is that correct?
>
> A. That's right. And then, of course, we had a

[9]Taxpayer was repaid $10,000, though the trial court found that the time of repayment was unspecified. (I R. 14.) Taxpayer asserts this repayment as fact indicating repayment was expected when the advances were made. Br. 20.) On taxpayer's offer of proof on motion for new trial, however, was asserted that the $10,000 was received in 1949 or 1950 from a decedent's estate. (III R. 4-5, 18; see I R. 71.) Thus, on taxpayer's own representation is obvious that receipt of this sum was fortuitous and based solely upon the unforeseen circumstance of a decedent willing taxpayer funds. It was in no way established that this bequest was foreseen when NMS was formed or as NMS progressed.

[10]It may be noted, for contrast purposes, that an organization as well established as the A.M.A. had, in 1956, 148,094 members out of a total of 218,061 physicians in the mainland United States. American Medical Directory (19th ed., 1956), pp. 11, 13.

> lot of members—in fact, we had some of them that belonged to the A.M.A. We had lots of members of the A.M.A. They switched over to our organization.

But by 1946, NMS did not have 100 regular dues-paying members (I R. 14); indeed, as of August 7, 1945, NMS had a deficit of expenses over income of $3,963.89 (I R. 17). Although taxpayer's original enthusiasm is understandable, by 1949, after four years of untiring effort expended in developing it, NMS could produce only 59 members and $1,429 in annual income (I R. 15) with the result that for the period August 23, 1949 to December 21, 1949, it had a net operating loss of $11,743.44 (I R. 67). Nevertheless, taxpayer continued to advance NMS funds. With his inside knowledge, taxpayer was, of course, well aware that NMS had few members and inadequate resources (I R. 15, 71) yet, despite this awareness, taxpayer continued his advances. In 1949, taxpayer contributed $11,694.70; in 1950, another $8,852.64; in the following years, over $3,500. (I R. 15.)

In *W. F. Young, Inc.* v. *Commissioner, supra*, the Young family had advanced funds to a corporation bearing their family name. The court, in sustaining a determination that the advances were gifts, commented that cases holding intra-family advances are presumed gifts should there be applicable, for advances by a family to a corporation bearing its name is comparable to an intra-family transfer. The gift presumption should apply here as well for NMS was in its early years taxpayer's alter ego. Taxpayer was NMS's founder and chief financial contributor—at NMS's inception he was

its inspiration and guiding force. As Captain Leahy stated in his letter to NMS (I R. 52):

> Dr. Zimmerman had an idea, and he toiled day and night to put his idea into being, besides so unselfishly devoting his whole time, he also made financial contributions, so that the seeds could be sown which have borne fruit, with the growth of the National Medical Society.
>
> * * *
>
> It behooves each and every one of us to put our shoulders to the wheel and get members, but not charlatans or crackpots, so let our slogan be "New Members," and repay a debt of gratitude to Dr. Hans Zimmerman.

Clearly, NMS was taxpayer's pet project. (I R. 21.) As indicated taxpayer never demanded repayment of his advances (I R. 20) nor did he charge NMS interest or demand security for his advances, all factors evidencing a gift or contributory intent. Taxpayer deducted some of the advances as charitable contributions and continued to advance funds when it was obvious NMS would never repay him. The District Court, based on the foregoing, could not have reached any other conclusion than it did (I R. 20):

> Likewise, where the advances are made under such circumstances as to negative any reasonable expectation of repayment, then even though obligations might constitute valid indebtedness for other purposes, they are not "debts" within the meaning of the Internal Revenue Code. *Gilbert* v. *C.I.R., supra.* If the putative lender knows that the borrower is without resources and likely never to have

any, it may be reasonable, with nothing further, to assume that he merely means to give the money, and no "debt" would result. *Shiman* v. *C.I.R.,* 60 F. 2d 65 (2nd Cir.). Here, judging from the financial condition of the Society, through the 11 years that Dr. Zimmerman kept it in business, he could not reasonably, at any time, have expected that he would be repaid.

The cases largely relied on by taxpayer (Br. 18-19) are clearly distinguishable and not in point. In *Dallas Rupe & Son* v. *Commissioner,* 20 T.C. 363, a civic-minded Dallas investment banker had loaned money to the Dallas symphony. The loans there were made at a time when responsible local leaders assured taxpayer that after a fund-raising campaign he would be reimbursed. Thus, taxpayer there was promised repayment by responsible people within a short, almost certain, time. The fund-raising campaign was, in fact, undertaken, although the amount raised was not enough to reimburse taxpayer. *Byerlite Corp.* v. *Williams,* 286 F. 2d 285 (C.A. 6th), involved the issue of whether a parent corporation's advances to a subsidiary was a loan or risk capital. In *Byerlite,* the subsidiary would never have had any chance of making profits (the subsidiary was set up to assume certain risks in dealing with foreign property); the financial risk would have been the same had taxpayer made the investment; repayment was expected within a few years; only minimum financing was needed for the subsidiary; and the advances were always treated as loans with accounts payable and receivable set up on the books of both companies. On these facts, the Sixth Circuit held a loan had been

intended. In *Island Petroleum Co.* v. *Commissioner,* 57 F. 2d 992 (C.A. 4th), the court there stated that a taxpayer could not treat an advance, the repayment of which was dependent upon a contingency, as a loss until the contingency had occurred. This is consistent with the Government's theory here, for in the instant case, the contingency of NMS's financial success has never occurred so that a debt cannot be said to have arisen.

C. The Trial Court's Findings of Fact Were Within the Scope of the Pretrial Order, and, in Addition, Were Made in Conformance With Rule 52 of the Federal Rules of Civil Procedure.

The taxpayer alleges that the trial court departed from the scope of the pre-trial order, wrongly denied taxpayer a new trial (Br. 26-34), and did not make technically adequate factual findings (Br. 35-42). We submit that taxpayer's contentions are without merit and are, in fact, fully contradicted by the record.

In its pre-trial order the court limited the issues as follows (I R. 11):

> ULTIMATE FACTS WHICH WILL BE DISPUTED
>
> 1. When the monies were delivered to the National Medical Society, did plaintiffs intend to make a loan or a gift to the Society?
>
> 2. When such monies were delivered, was there any reasonable expectation that the Society could repay the monies to plaintiffs?
>
> 3. Assuming that a loan was created, what year or years was the bad debt created?

As can be seen from the trial transcript (II R. 56-57), and contrary to taxpayer's assertion (Br. 27-28), the

court was not interested in the amount taxpayer advanced for mere accounting purposes, but rather to discover the nature of such advances, as shown by the following colloquy (II R. 56-57):

> THE COURT: I am following you. I am right with you.
>
> MR. YOUNG: And so no attempt was made to give an exact accounting. We were merely trying to establish the nature of the obligation.
>
> THE COURT: I agree. So am I.
>
> MR. YOUNG: So long as we understand one another, I have no objection.

Clearly, it was necessary for the trial court to discover the nature of the advances if it was to find whether or not a debt existed, and certainly this latter finding was within the scope of the pre-trial order. Indeed, it seems reasonable to assume that a knowledge of the amounts advanced over the years by taxpayer for the purpose of contrasting with what must be admitted was NMS's precarious financial position during the same period was essential to a determination of whether repayment could reasonably be expected which, in turn, was one of the elements to be considered in ascertaining whether a loan or contribution was intended.

It is to be noted, moreover, that at the trial level taxpayer did not object to any alleged departure from the scope of the pre-trial order. Nevertheless, even if taxpayer's later objection be considered timely, it is clear that none of the alleged evidence outlined at taxpayer's offer of proof on a motion for new trial could in any

way have aided his cause. Rather, some of the proffered evidence substantiated the Government's as, for example, taxpayer's assertion (III R. 3-6) that a $10,000 repayment to taxpayer was made as the result of a fortuitous acquisition from an estate rather than out of any preconceived or planned-for earnings by NMS. A letter from Dr. Gobar (I R. 68-70; see III R. 6-7), showed that by 1949 the financial position of NMS was precarious, and that NMS's resources were meager (I R. 68). The letter also speaks of taxpayer's statement "I don't much care what its (the NMS) future will me" (I R. 69), hardly indicative of a man worried about a debt owed to him. Moreover, the letter (I R. 70) speaks of the large sum taxpayer "altruistically spent in the interests of the Society."

It hardly need be said that taxpayer's contention (Br. 35) that the decision must be set aside because the findings of fact are unnumbered or the word "find" is not used, is clearly without merit. Rule 52 of the Federal Rules of Civil Procedure does not contain any such requirement. *Stone* v. *Farnell,* 239 F. 2d 750 (C.A. 9th); *Trentman* v. *City and County of Denver, Colo.,* 236 F. 2d 951 (C.A. 10th), certiorari denied, 352 U.S. 943; *Cross* v. *Pasley,* 267 F. 2d 824 (C.A. 8th). And it is also apparent that comments on creditability of taxpayer's sole witness (himself) need not be mentioned. See *Pacific Homes* v. *United States,* 230 F. 2d 755, 761 (C.A. 9th) (concurring opinion); *Helvering* v. *Nat. Grocery Co.,* 304 U.S. 282, 295, rehearing denied, 305 U.S. 609. We submit that just a glance at the trial court's findings and opinion will clearly establish that findings of fact were adequately made.

D. Assuming, Arguendo, That a Debtor-Creditor Relationship Existed Between Taxpayer and NMS With Respect to the Advances Made by Him, the Taxpayer Has Failed to Establish by Competent Evidence Which, If Any, of the Years 1947 to 1955 Such Advances Became Worthless as Required by Section 166 of the 1954 Code.

Section 166 allows as a deduction debts that have become worthless within the taxable year. It is well established that the burden is upon the taxpayer to show in which year an alleged debt became worthless. *Seaboard Commercial Corp.* v. *Commissioner,* 28 T.C. 1034, 1053-1054; *O. Bee, Inc.* v. *Commissioner,* decided August 17, 1959 (1959 P-H T.C. Memorandum Decisions, par. 59,160); *cf., San Joaquin Brick Co.* v. *Commissioner,* 130 F. 2d 220 (C.A. 9th). The taxpayer, in his complaint, did not specify in which year the alleged "debt" in the instant case became worthless, but rather, in shotgun style, alleged the "debt's" worthlessness for *any* of the years 1949 through 1955. In its pre-trial order the District Court noted that the taxpayer claimed a bad debt loss for either of the years 1949-1955 (I R. 9) and, in its opinion (I R. 15-16), only commented that taxpayer testified that he definitely determined in the year 1955 that there was no hope of ever recovering the $41,247.73, but this does not establish that the alleged debt was not already worthless. The District Court did not make a specific finding as to the year of worthlessness because from the record it is apparent the taxpayer did not prove that fact. Even now, on appeal, taxpayer in his "statement of the case" (Br. 2), states the years involved to be "1955 or prior allowable years" and does not allege any one single year wherein the debt has become worthless. The exact year of worthlessness is of course, material, since the total amount advanced by

taxpayer to NMS increased as the years went along. Accordingly, as taxpayer has not shown by competent evidence the year in which the alleged debt became worthless, taxpayer can in no way be said to have met the burden imposed upon him by the statute.

E. In Any Event, If Taxpayer's Advances to NMS Are Deemed to Have Established a Debtor-Creditor Relationship Between Them, Such Advances Constitute Non-Business Debts Within the Contemplation of Section 166 of the 1954 Code.

As an alternative argument, the Government requests for the reasons stated, *infra,* that if taxpayer's advances be determined to be a debt within the meaning of Section 166 of the 1954 Code that the advances be also determined a nonbusiness debt within the contemplation of that statute as opposed to a business debt.

The purpose of NMS was to serve *all* the healing professions, not only naturopaths. (See I R. 20.) Indeed, there was an already extant association for naturopaths (II R. 7) so it is clear that NMS was not a necessity insofar as taxpayer's particular profession was concerned. Moreover, taxpayer testified that he had no business other than naturopathy. He stated (II R. 44-45):

> Q. I see. And your profession is solely a naturopath, is that correct?
>
> A. Yes, I am a Naturopathic Physician.
>
> Q. You have no other business, is that correct?
>
> A. I can't understand you too well.
>
> THE COURT: You have no other business?
>
> THE WITNESS: Oh yes, I have, at this time, since I am not too active in my practice. I have rental units, real estate.

MR. LUM: From 1943 up to—

THE COURT: Confining it to that period from '43 to '55.

Q. (By Mr. Lum) 1943 to 1955?

A. No. 1943 to 1955?

Q. Yes.

A. Yes.

Q. What other business did you have, if anything?

A. I understood you to say I had no business.

Q. I will amend that. Besides being a Naturopath?

A. I had no other business.

Furthermore, taxpayer's relationship to NMS was that of a shareholder in a corporation. Internal Revenue Code of 1954, Section 7701(3) and (8). It is well established that the business of a corporation is separate and distinct from that of its shareholders and that a loss from a loan made to a corporation by a mere shareholder which becomes worthless is not incurred in the shareholder's individual trade or business as required by Section 166 of the 1954 Code. *Holtz* v. *Commissioner,* 256 F. 2d 865 (C.A. 9th). As the Fifth Circuit recently stated in *Whipple* v. *Commissioner,* 301 F. 2d 108 (C.A. 5th), certiorari granted, October 22, 1962 (p. 109):

> * * * the usual rule [is] that where the controlling stockholder of a corporation is unable to obtain repayment of moneys he advances to his corporation

> to bolster up its operating possibilities this is generally considered a non-business bad debt. This follows because in such a case the loan or advance made by the taxpayer to the corporation is no part of any business which he is engaged in individually. It is an advance or loan made by him to enable his wholly owned corporation to make a profit.

It is clear that NMS was "no part of any business" n which the taxpayer was engaged, i.e., the practice of naturopathy. Moreover, the instant case presents an even stronger situation for calling the alleged debt a nonbusiness debt than that existing in the *Holtz* nd *Whipple* cases, *supra.* Here, taxpayer, from the tandpoint of ownership, was not even a controlling hareholder of NMS. His ownership rights in that rganization were solely those of a single member and he same as any other member. Also, NMS had other fficers who played an active role in managing the rganization after 1946, when taxpayer returned to Hawaii. In addition, taxpayer never received a salary r any other remuneration from NMS. Even the NMS ournal, an expected moneymaker, was, apparently nsuccessful and was abandoned. Thus, the record learly established that as the years advanced taxpayer's onnection with NMS's active management diminished onsiderably.

It is well settled that if a taxpayer renders services organizing, financing and managing a corporate busiess, without receiving any form of consideration, solely or the purpose of building up the corporation's busiess and thereby profiting as one of the shareholders, he

is not engaging in a business of his own and gains a return only as an investor. *Dalton* v. *Bowers,* 287 U.S. 404, and *Burnet* v. *Clark,* 287 U.S. 410. But, it is obvious that here the taxpayer derived no profit from his connection with NMS, not even as a stockholder-member. Furthermore, taxpayer's advances to NMS were not prompted by any current profit motive—not even an expectation that he would derive dividends from NMS's operation such as would be anticipated by most shareholders of a corporation in making loans to the latter. It is clear, therefore, that the loss here claimed was not incurred in taxpayer's business of practicing naturopathy, which admittedly was his sole and only business. As the District Court found (I R. 20-21):

> * * * it was his [taxpayer's] fight against the Association [AMA] which led him to carry on with his intensive and time-consuming organizational work of his pet project—the National Medical Society.

Thus, the principle purpose of the organization of NMS was to enable certain healing professions to carry on a fight against the American Medical Association with respect to which taxpayer had become deeply embittered (I R. 12), an admittedly non-business purpose.

On these facts, taxpayer's unrepaid advances, even if considered a debt, are clearly a nonbusiness debt. *Holt* v. *Commissioner, supra*; *Whipple* v. *Commissioner, supra.*

CONCLUSION

The decision of the District Court is supported by substantial evidence, can in no sense be said to be clearly erroneous, and should therefore be affirmed on appeal.

Respectfully submitted,

LOUIS F. OBERDORFER,
Assistant Attorney General,

LEE A. JACKSON,
ROBERT N. ANDERSON,
ALAN D. PEKELNER,
Attorneys,
Department of Justice,
Washington 25, D. C.

HERMAN T. F. LUM,
United States Attorney.

March 28, 1963.

CERTIFICATE

It is hereby certified that counsel for the appellee has examined the provisions of Rules 18 and 19 of this Court and that in his opinion the foregoing brief conforms to all requirements.

ALAN D. PEKELNER,
Attorney.

March 28, 1963.

Appendix

APPENDIX

Internal Revenue Code of 1954:

SEC. 166. BAD DEBTS.

(a) *General Rule.*—

(1) *Wholly worthless debts.*—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) *Partially worthless debts.*—When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) *Amount of Deduction.*—For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) *Reserve for Bad Debts.*—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

(d) *Nonbusiness Debts.*—

(1) *General rule.*—In the case of a taxpayer other than a corporation—

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss re-

sulting therefrom shall be considered a los from the sale or exchange, during the taxabl year, of a capital asset held for not more tha 6 months.

(2) *Nonbusiness debt defined.*—For purpose of paragraph (1), the term "nonbusiness debt means a debt other than—

(A) a debt created or acquired (as the cas may be) in connection with a taxpayer's trad or business; or

(B) a debt the loss from the worthlessnes of which is incurred in the taxpayer's trade c business.

* * * * * * *

(26 U.S.C. 1958 ed., Sec. 166.)

SEC. 6511. LIMITATIONS ON CREDIT OR REFUND.

* * * * * * *

(d) *Special Rules Applicable to Income Taxes.*-

(1) *Seven-year period of limitation with r spect to bad debts and worthless securities.*—I the claim for credit or refund relates to an ove payment of tax imposed by subtitle A on accou of—

(A) The deductibility by the taxpayer, u der section 166 or section 832(c), of a debt a debt which became worthless, or, under se tion 165(g), of a loss from worthlessness of security, or

(B) The effect that the deductibility of debt or loss described in subparagraph (A) h

on the application to the taxpayer of a carryover,

in lieu of the 3-year period of limitation prescribed in subsection (a), the period shall be 7 years from the date prescribed by law for filing the return for the year with respect to which the claim is made. If the claim for credit or refund relates to an overpayment on account of the effect that the deductibility of such a debt or loss has on the application to the taxpayer of a carryback, the period shall be either 7 years from the date prescribed by law for filing the return for the year of the net operating loss which results in such carryback or the period prescribed in paragraph (2) of this subsection, whichever expires the later. In the case of a claim described in this paragraph the amount of the credit or refund may exceed the portion of the tax paid within the period prescribed in subsection (b)(2) or (c), whichever is applicable, to the extent of the amount of the overpayment attributable to the deductibility of items described in this paragraph.

* * * * * * *

(26 U.S.C. 1958 ed., Sec. 6511.)

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.166-1. *Bad debts.*

* * * * * * *

(c) *Bona fide debt required.* Only a bona fide debt qualifies for purposes of section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable

sum of money. A gift or contribution to capital shall not be considered a debt for purposes of section 166. The fact that a bad debt is not due at the time of deduction shall not of itself prevent its allowance under section 166.

* * * * * * *

Sec. 1.166-2. *Evidence of worthlessness.*

(a) *General rule.* In determining whether a debt is worthless in whole or in part the district director will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor

* * * * * * *

Sec. 1.166-5. *Nonbusiness debts.*

(a) *Allowance of deduction as capital loss.* (1) The loss resulting from any nonbusiness debt's becoming partially or wholly worthless within the taxable year shall not be allowed as a deduction under either section 166(a) or section 166(c) in determining the taxable income of a taxpayer other than a corporation. See section 166(d)(1)(A).

(2) If, in the case of a taxpayer other than a corporation, a nonbusiness debt becomes wholly worthless within the taxable year, the loss resulting therefrom shall be treated as a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. Such a loss is subject to the limitations provided in section 1211 relating to the limitation on capital losses, and section 1212, relating to the capital loss carryover and in the regulations under those sections. A loss on a nonbusiness debt shall be treated as sustained

only if and when the debt has become totally worthless, and no deduction shall be allowed for a nonbusiness debt which is recoverable in part during the taxable year.

(b) *Nonbusiness debt defined.* For purposes of section 166 and this section, a nonbusiness debt is any debt other than—

(1) A debt which is created, or acquired, in the course of a trade or business of the taxpayer, determined without regard to the relationship of the debt to a trade or business of the taxpayer at the time when the debt becomes worthless; or

(2) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

The question whether a debt is a nonbusiness debt is a question of fact in each particular case. The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph. The use to which the borrowed funds are put by the debtor is of no consequence in making a determination

under this paragraph. For purposes of section 166 and this section, a nonbusiness debt does not include a debt described in section 165(g)(2)(C). See § 1.165-5, relating to losses on worthless securities.

* * * * * * *

CECIL F. POOLE,
United States Attorney,

RICHARD L. CARICO,
Assistant United States Attorney.